DOW THEORY LETTERS INC.

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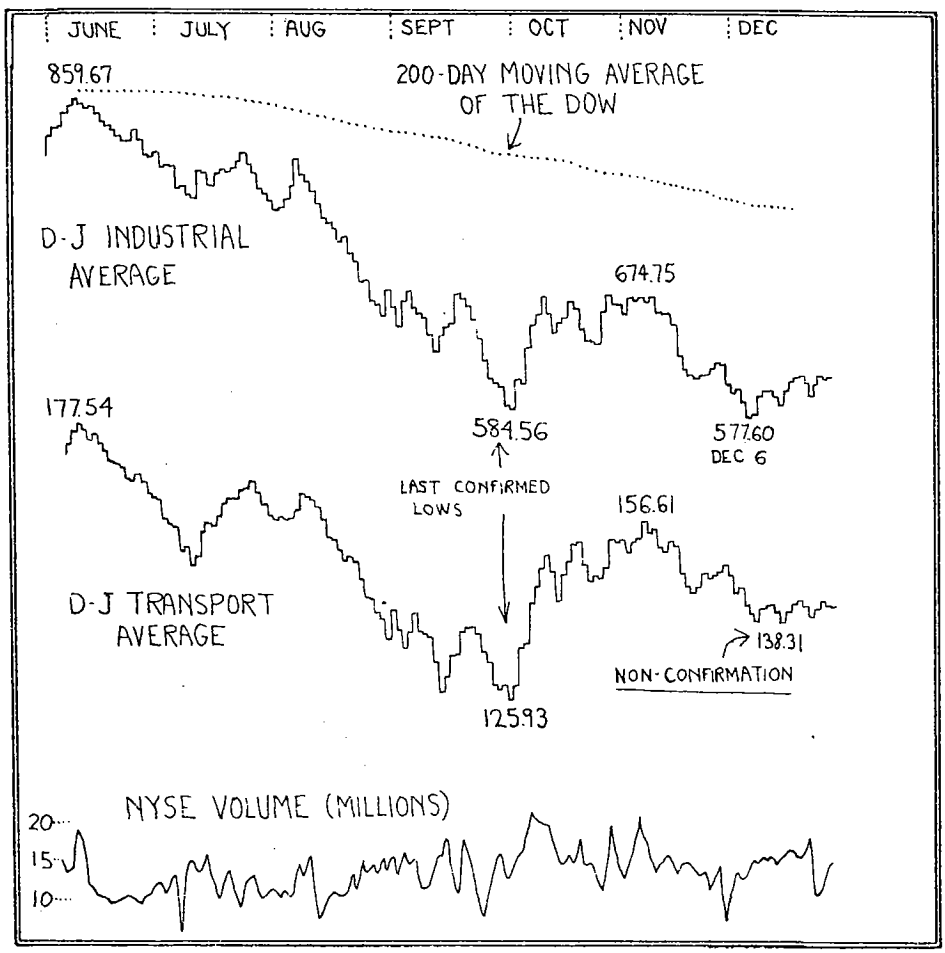
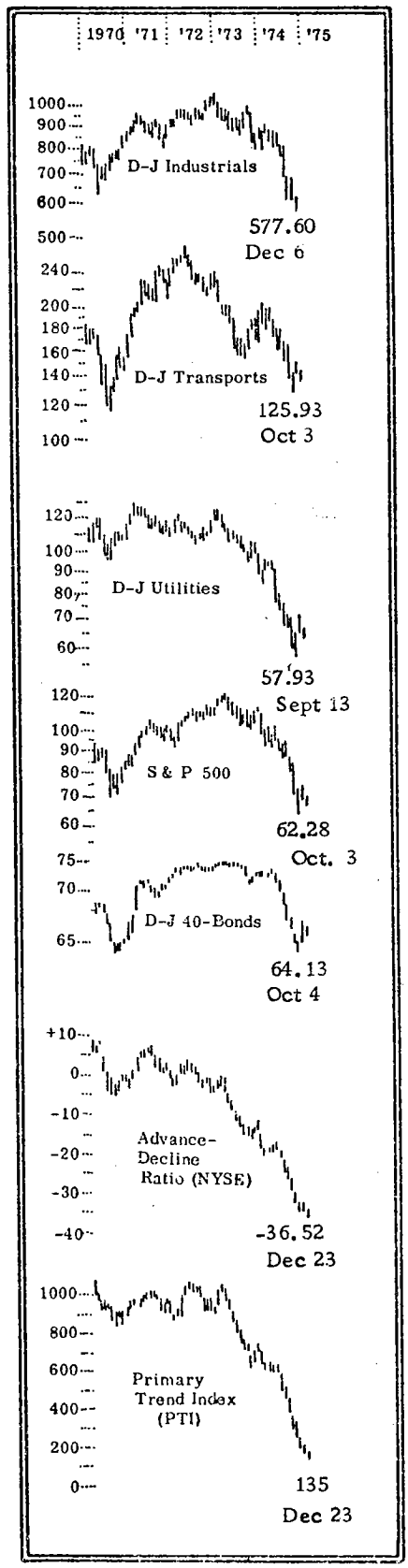
"One fool can ask more questions than ten wise men can answer." Zen saying.

In the December 20 "Special Report" I stated that in my opinion there was a better than 50/50 chance that the bear market ended at the October 3 and 4 lows (for the D-J Averages). What does that actually mean? Turning to the chart of the Averages below, we see that the October lows were 584.56 for Industrials, 125.93 for Transports. These were the last lows reached jointly by the two Averages. On December 6 (two months later) Industrials recorded a new bear market low of 577.60. Transports, however, refused to confirm. The lack of confirmation negated the significance of the December 6 Industrial low. Unless both Averages now break to new lows (Industrials below 577.60, Transports below 125.93) history will record October 3 as the bottom for the bear market (although December 6 will stand as the low day for the D-J Industrial Average alone).

What does all this say about the primary trend right now? On a strict or orthodox Dow Theory interpretation, the trend (in today's case, the bear trend) is conceded to remain in force until proved otherwise. We can deduce, we can infer, we can believe differently, and we can act on our inferences (as I have suggested we do in the Special Report). But it is only after the Averages give a bull signal (and this must occur following a bear market third phase) that we can know for certain that the tide has turned. Since I have indicated that the bear market is in its third phase, any forthcoming bull signal should be accepted as absolutely valid.





What would constitute a primary bull signal? The Averages rallied to November peaks of 674.75 for Industrials, 156.61 for Transports. A sizable decline of a month's duration followed. That decline took Industrials to a new low, a low which was unconfirmed by Transports (see page 1 chart). If any forthcoming rally succeeds in taking the Averages above their November peaks, I would state that we are in a new bull market.

Many will insist that a bull market cannot materialize here, that such an idea is a total absurdity. Others will say that conditions in the economy simply do not allow for a bull market. Still others point to the disaster which is sure to confront corporate profits, the chaotic world monetary conditions, the impending war in the Mid-East, the oil crisis, on and on. And all of this may conceivably be true, but it is also very evident. If nothing else, we are in the best reported and documented slump in history. Every scrap of adverse economic news is splattered over the newspapers and magazines. But the stock market knows all of it — and MUCH, MUCH MORE. So once again I'll say that the function of the market is to discount, to look ahead. Failure to understand that means failure to grasp the meaning of the market.

In my opinion, if we do get a primary bull signal the market will be telling us that conditions are about to change, and that we damn well better change our minds (and throw out our preconceived notions about what "has to happen" according to Time Magazine, the Wall Street Journal, the President's advisors or anyone else). In late 1973 Business Week polled 2,000 security analysts and advisors on the outlook for 1974. The consensus was that the Dow would be at 923 on June 30, 1974 and at 994 at year end 1974. Could any group have been more wrong? So you better face it, operating in the stock market is a lone business, and if you insist on a consensus of "experts" or a green-flag go-ahead from Mr. Ford or your broker, you better save your money and your time and stay in your own backyard. One of my jobs is to teach people not to argue with the market. Those who do will experience the financial counterpart of running headfirst into a brick wall.

"All right, Russell," you ask, "but what would have to happen to indicate a resumption of the bear market?" Answer: Following the current rally, if one or both Averages fail to better their November highs and they turn down and break their October-December lows, then there is no question about it, the bear market will be resuming its third and final phase. How far down it will go, in that case, no man alive knows. (November highs 674.75, 156.61; October-December lows 577.60, 125.93).

The single most bearish argument at this time is the time-honored Dow Theory precept that a trend remains in force (in this case a bear trend) until proved otherwise. The fact is that we have not yet received the "otherwise" proof. Nevertheless, we are entitled to infer a possible bottom, and for this reason I want to go over some of my reasons for thinking that we may have passed the lows.

(1) The very essence of Dow's Theory is values. Over any reasonable length of time, said Dow, "the movement of stocks is towards values." As outlined in the Special Report, the Dow Industrials are now yielding over 6% and are in a real value area. Many other stocks (hundreds of them) are now selling at 75% to 90% below their bull market highs; they are selling below known values. Yields of 7% to 10% are easy to find among good quality shares, and a long list of stocks (including the Dow Industrials) are now selling below book (or break-up) value. In short, the stock market is now thoroughly deflated (although obviously it can always get "more deflated").

(2) Any time during the third phase of a bear market that we see one Average break to a new low unconfirmed by a new low in the other, there is always the possibility that the final lows have been seen. I always compare investor and public sentiment at such points. For instance, the economic news at the December lows was considerably worse than it was at the earlier October lows. Yet Transports refused to confirm on the downside at the December lows. Why? What was the market telling us in the face of December's dismal economic news?

(3) As seen on the long page 1 chart, the various Averages have (so far) failed to confirm the December low in the Dow Industrial Average. The non-confirmers include the D-J Transports, the D-J Utilities, the D-J 40-Bonds and the Broad S & P 500 Stock Average. Why was there so much resistance to the downside as the news turned blacker? I have to take this action as positive for the market.

(4) Many major declines have terminated with a low in the Dow, but later new unconfirmed lows in the advance-decline ratio (i.e., unconfirmed by the Dow). For instance, the severe 1957 smash ended with lows in both the Dow and the A-D ratio in October, but the A-D ratio sank to new unconfirmed lows in November. The severe 1962 decline ended with lows in the Dow and the A-D in June, but the A-D registered a new unconfirmed low in October. The recent 1970 collapse ended with May lows in the Dow and the A-D, but the A-D recorded a new unconfirmed low in July. Each of these unconfirmed new lows in the A-D ratio proved to be a turning point for the market. The Dow and the A-D broke to lows on December 6, 1974. The A-D recorded a new unconfirmed low on December 23. That non-confirmation could have represented the turning point.

(5) The 34-week momentum line for the Dow (see Letter 617, page 4) hit a bear market low of 68 in early December, 1974. Last week it turned up through a secondary declining trendline. The downside momentum in the Dow appears to be ebbing.

(6) Barron's Low Priced Stock Index hit a peak of 413 in 1968. Last week it dropped to 116. This indicates a great dearth of speculation and a collapse in low-priced shares. Both are necessities for a bear market bottom.

(7) Public sentiment is now very depressed. People are calling and writing to tell me how bad things are in their areas or in their own businesses. It is becoming almost fashionable to be bearish. The news media is headlining the whole economic decline. This is the sort of atmosphere in which bear market bottoms are formed.

(8) I have tabulation on the short interest in the 30-Dow stocks going back to 1931 (courtesy of my friend Bill Gordon in Florida). In November the total shorts in the 30-Dow stocks jumped to 1,496,000, highest level in history. The latest (December) figure is almost the same, 1,450,000 shares short. A lot of people are betting on a further collapse in the Dow. Yet the Industrials don't seem to want to oblige them.

(9) Here are a few interesting items from Yale Hirsch's Stock Trader's Almanac. There have been ten decades since 1871. Referring to the "decennial pattern" (i.e., 1890 to 1900, 1900 to 1910, etc.) the 5th years have been the most bullish (i.e., 1935, 1945, 1955, 1965). Of the ten 5th years since 1871, nine have been up-years and only one has been down. Next, since 1900 there have been seventeen Presidential elections. Taking the pre-election years, twelve have been up-years and only five have been down. Furthermore, a pre-Presidential election year that is also a 5th decennial year occurs only once in twenty years. The year 1975 is such a year.

(10) The monetary conditions are now becoming a plus factor for the stock market. As Dr. Kaufman of Salomon Bros. stated in his latest (December 20) authoritative report, "The Federal Reserve is steadily and persistently easing conditions in the money market.... The four-week average level of the seasonally adjusted money supply has increased at an annual rate of 10.1% during the past four weeks."

(11) Study the statistics below:

Date	Dow	A-D ratio	NYSE daily new lows
Sept. 13	627.19	-34.57	661 (low)
Oct. 4	584.56	-34.83	234
Dec. 6	577.60 (low)	-35.72	297
Dec. 24	598.40	-36.22 (low)	99

The figures show the ebbing of downside strength. The worst of the new lows occurred on Sept. 13. With a new low for the Dow on Dec. 6th, daily new lows (despite a falling A-D ratio) shrank to 297. On December 24, with vicious tax selling in force, new lows contracted to 99. In other words, fewer and fewer stocks were breaking down, despite bad news and another new low on the A-D ratio. It should be noted that abysmal news in the auto industry has also failed (so far) to take bellwether General Motors below its recent 20-year low of 28-7/8.

(12) Readers are going to have to indulge me in this one, but I must admit to a personal fascination with Fibonacci numbers, so bear with me. Fibonacci numbers or series were so named by the great Italian mathematician, Leonardo de Pisa (called Fibonacci). The Fibonacci series (FS) have the following properties, among others (1) The sum of any two numbers form the next in the series as 1 and 1 equals 2, 2 and 1 equals 3, 3 and 2 equals 5, and the series continues to 8, 13, 21, 34, 55, 89, 144, 233, 377, 610, 987, and so on. (2) The ratio of any number to the next higher is 61.8 to 100. (3) The ratio of each number to the next lower is 161.8 to 100.

Of extreme interest is the fact that FS appears everywhere in nature, such as the 5 appendages of man (head, two arms, two legs), 5 face openings (two nostrils, two eyes, mouth), 5 fingers and toes, 21 is the age of maturity, 13 the beginning of teen-age years, musical octaves are made up of 13 keys (5 black, 8 white), trees usually branch in FS numbers, on and on.

Since the stock market is the work of man, it is not surprising that there are 3 phases in both bull and bear markets. Bull markets tend to have 5 main swings, 3 up and 2 down, while bear markets tend to have 3 main movements, 2 down and 1 up.

I will list below a few of the FS "coincidences" that have occurred in the timing of major market points.

1907 panic low to 1962 panic low 55 years.
1932 crash bottom to 1937 bull market top 5 years.
July, 1932 bear bottom to March, 1937 bull top 55 months.
September, 1929 bull top to July, 1932 bear low 34 months.
1949 major bottom to 1962 bottom 13 years.
1937 bull top to 1942 bear market bottom 5 years.
1921 depression low to 1942 depression low 21 years.
January, 1960 top to October, 1962 bottom 34 months.

Could all that (and I could provide many more) be coincidence? Perhaps, but I personally feel that it is beyond coincidence. At any rate, let's update the study.

According to my data, the year 1970 was a very important one. On May 26 of that year the Dow hit a low of 631.16, its lowest point of the bear market (that began in 1966).

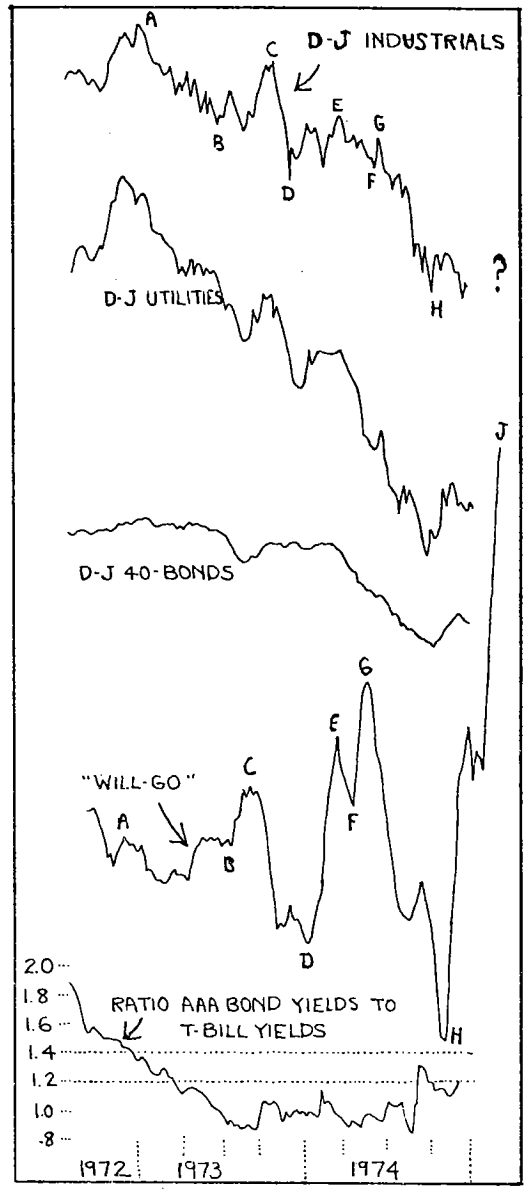
From 1949 (beginning of the great bull market) to 1970 was 21 years.
From 1957 (end of the second phase of the bull market) to 1970 was 13 years.
From 1962 (the year of the panic smash) to 1970 was 8 years.
These FS relationships indicated to me that 1970 was a key year.

Here is an exact excerpt from Letter 582 (November 30, 1973), a paragraph that most of my readers have probably forgotten about: "NOTES & THOUGHTS: I have been doing a good deal of additional thinking regarding the Fibonacci timing series as discussed in detail in the last Letter. In that report I stated that 1975 could be the year of the bear market's end. The following

relationships, however, strike me as worth noting. From the bull market top of 1966, a span of 8 years would take us to 1974. From the May, 1970 bear market low to December, 1974 would be 55 months. The number 55 is a FS number, as is 8. Thus I feel that December, 1974 will be a month worth watching, as far as Elliott is concerned. Conceivably, the bear market could end there."

Here's an added thought. When the numbers making up 1974 are added, they total 21, a FS number. At any rate, on December 6, 1974 the Dow dropped to a closing of 577.60, its lowest level of the bear market. It would be more than interesting if that low held.

INDICATORS: Here's a chart that I haven't shown since Letter 604, at which time the chart's appearance was most decidedly bearish. Now, the picture is changing, and it is time to take another look. The top line traces the D-J Industrials through the period of August, 1972 to the present. We'll use the Dow for reference purposes and say that it's indicative of "the market".



Veteran readers know that I consider the trend of the D-J Utilities and the D-J 40-Bonds as important "background influences" on the general market. Both of these Averages are very sensitive to changes in interest rates and the availability of money. When the two Averages (together) are in rising trends, I accept this as constructive for common stocks. Conversely, when the two Averages are in established downtrends, I take this as negative for Wall Street (which thrives on positive money conditions).

As seen on the chart, both of these Averages were in established downtrends all through 1973 and most of 1974. On September 13 the D-J Utility Average recorded an extraordinary twenty-year low of 57.93. On October 4 the D-J 40-Bond Average touched an all-time low (!) of 64.13. Neither Average has since broken those lows, and I believe there is a better than even chance that they will not do so in the foreseeable future. Thus, I grade the Bonds and Utilities with a plus.

Next, I show "Will-Go," so named because wherever it travels, the Dow will go (or at least, tends to go). Will-Go is a function of the yield-spread between Barron's 10 Hi-Grade Bonds and the Dow Industrials. This spread (shown in Barron's each week) is compared with the figure of five weeks ago, and the accumulated totals are plotted ten weeks ahead of the Dow. In other words, Will-Go has a ten-week lead (approximately). It is important to remember that Will-Go deals with direction, not extent.

Will-Go called for a market low around the middle of October, (H on chart) and in reality the D-J Averages did register their last joint lows in early October. Will-Go has been moving up for 19 weeks since its extreme low of August 9. The move has been the largest I have ever seen in Will-Go. Plotting 10 weeks ahead would mean that Will-Go was calling for a Dow rise from October into late-February. (Remember, Will-Go, like all market indicators, is fallible).

The last indicator shows the ratio of Aaa Industrial Bond yields to the yields on US Treasury bills. This indicator has been below 1.2 and into bearish territory since February of 1973. The indicator heads down when short-term (bill) yields move above long-term bond yields, a situation reflecting tight money conditions. If it rises above 1.4 we will have a "strong buy signal". The last ratio figure was 1.17, a hair below a buy signal.

Conclusion: This whole sweep of indices appears to be now moving into the generally bullish area. The background for stocks, from this standpoint, is turning positive.

STOCKS, STRATEGIES, TACTICS: There are a number of actions (or inactions) that can be taken at this time. (1) The investor can play it safe and adhere firmly to the thesis that we are still in a primary bear market and that in due time the various Averages and most stocks will break to new lows (unless, of course, we receive contrary evidence in the form of a classic bull signal). Those who follow this line of reasoning will be perfectly willing to wait out the situation and to pay higher prices (if necessary) in the event of a bull signal. They might also prefer to wait for a crossing of the moving averages (MA's) of the Dow as outlined last in Letter 612. Since the 13-week and 50-week MA's are now 131 points apart, it would take a number of months before such a crossing and buy-signal could occur. Nevertheless, I have no objection to this kind of "safe market policy".

(2) One can hope that the important series of non-confirmations outlined earlier in this Letter will not reverse themselves. If these non-confirmations hold, it is probably that we are now at or somewhere near the lows for the bear market. If one wishes to act on these inferences, one can purchase a small pilot group of stocks that would provide limited losses even if the market broke and embarked on another major bear leg from here. Furthermore, one could sell off the pilot purchases if the Dow Industrials and Transports both penetrated their bear market lows. Under these conditions the seller would be paying the "cost of insurance" against a

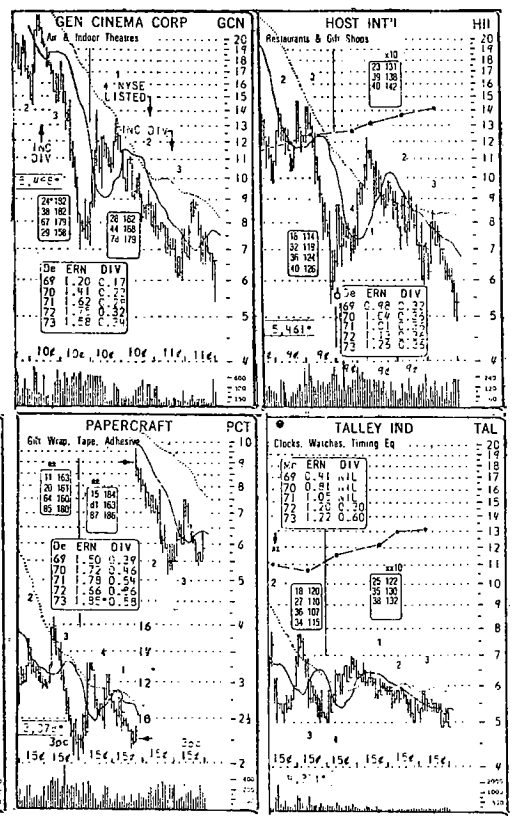
possible or conceivable economic catastrophe (which is what the market could be telling us in the event of another major and extended decline from this level). I see nothing wrong with this pilot-position policy either, but I would limit any purchases to no more than around 15% of available funds.

The ultra-conservative investors (group 1 as mentioned previously) will have no more than academic interest in stock selection, but the following is presented for those who want to assume early pilot positions in this market. Of the thirty Dow Industrials, I feel that the following offer real value and can be purchased as a package. American Can on a relative strength basis has outperformed the market since late 1973. At a price of around 29 with a $2.20 dividend, AC yields a good 7.6%. This blue chip hit its bull market high of 64 in 1967, and it's now selling at 55% below its old high. General Foods, down from its bull market high of 53-7/8 reached in 1961 (!) and now yielding 8% on a $1.40 dividend (current price around 17½). Woolworth, down 84% from its 1971 bull market high of 55-3/4, and selling at less than 1/3 of its book value. A yield of 13.3% on its current $1.20 dividend although the stock would "seem" to be discounting a dividend cut. At around 9, Woolworth is back to prices not seen since the 1940's. United Aircraft, down from the bull market high (1967) of 111½, and now acting well. Recent annualized earning for UA are over $6, and I wish the $1.80 dividend were higher, but at a price of 32 the yield here is 5.6%. UA acting better than the market for months now.

So that's a package of four Dow stocks that are well deflated. At their respective highs, a share of each would have cost you $285. Now you can buy a share of each for $88, a discount of almost 70%. But, you say, 100 shares of each is a lot of money to tie up if this market swoons and we have to run for the exits. All right, (1) skip them, (2) buy an even dollar amount or an odd-lot of each if you want, or (3) put your speculative money in another area.

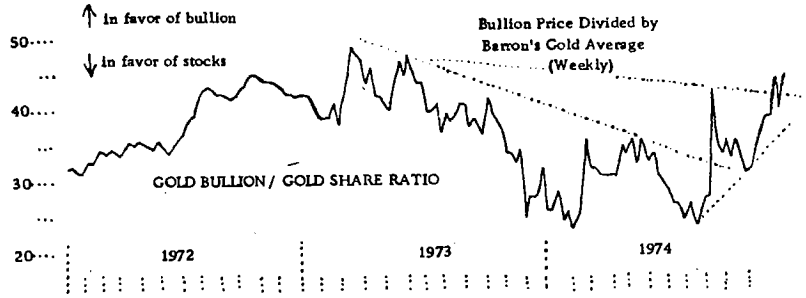
The other area is the one I drew attention to in the Special Report. This is the area of the hugely deflated shares that in many cases are now selling at 80% to 90% off their peak prices.

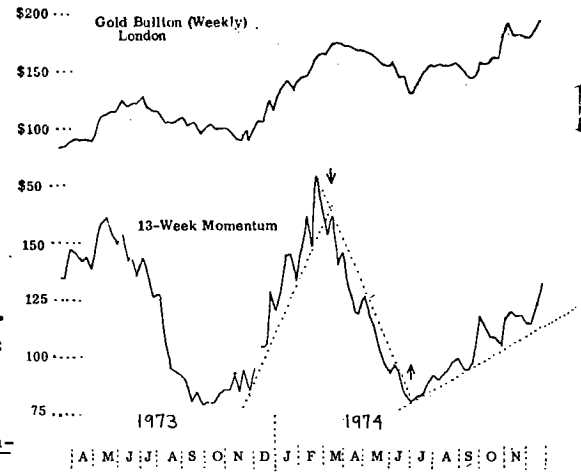
To the Special Report's list I will add the following, but again you will have to do some research on these or get together with your broker and see what he can do with figures. I like Host International which sold as high as 48 back in 1969 when Wall Street was feeling optimistic. It sells at an 88% discount now to yield 6.5% on a 36¢ dividend. General Cinema was loved at 55 in 1972, but now it's down at 6½ with an indicated 44¢ dividend to yield 6.8%. Melville Shoe was grabbed at its 1972 price of 39, but now it's around 6 with an indicated 45¢ dividend. Talley Industries was banging around the middle 60's in 1968, and now it's been banged down to just over 5. A 60¢ dividend here figures out to 11.7%. Papercraft looked beautiful at 1971's high of 45. You can buy it now for 6½ with a dividend of 60¢ to yield 9.2%. So there we have five more choices for the intrepid "early birds" who are willing to take a chance. As I see it, 100 shares of each of these would cost you about $3,000 which is a lot better than the roughly $25,000 you would have paid for them at their respective highs. And if they do drop say 25% in the next few months you will be sitting with a paper loss of $750, which is not the end of the world. At least you'll have the satisfaction of knowing that you've been buying America for literally 10¢ on the dollar. (Charts courtesy of Quote, PO Box 213, Wichita KS 67201). And by the way, the little boxes show the latest quarterly earnings plus the latest earnings for the last four quarters. For instance, Talley earned 38¢ for the third quarter and $1.32 for the four quarters ending with the third quarter.



GOLD: Recent Letters have been hammering at the fact that on a relative strength basis the movement is towards gold bullion (and coins) rather than towards gold shares. Back in the October 9, 1974 letter (611) I introduced my gold bullion/gold share ratio chart, and I stated that for whatever reason, the ratio was moving in favor of bullion. That chart has been included in almost every Letter since. In Letter 615 I showed a rising trendline in favor of bullion, since by this time the trend had become unmistakable. Last week (see chart page 6) the ratio rose to a new 1974 high in favor of bullion. I have been asking readers to cut down gold commitments to 25% of total assets with half in shares (which obviously entailed a cutback in share holdings) and half in coins.

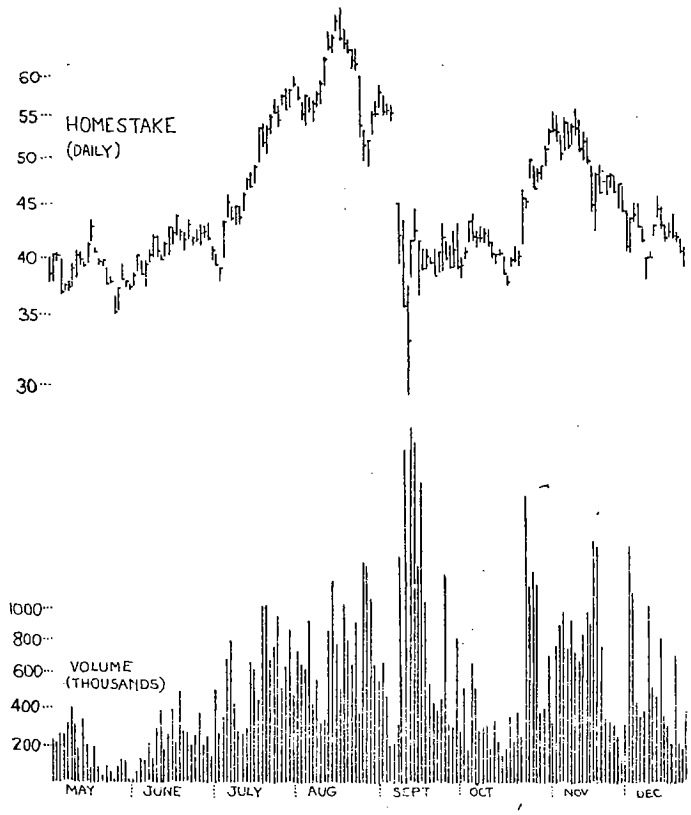
"What's happening to the shares," I am asked. "Why don't they move with gold?" Here's my answer to the best of my knowledge, intuition and ability. (1) With gold legalization here, people are opting for what they can put in the vault rather than for the gold stock certificates. They are tired of worrying about corporate problems, political problems, social problems. (2) Investors are afraid that gold shares may have already discounted the best that lies ahead from a share-earning standpoint. "The best" could be say $200 to $250 gold. If so, gold shares may settle back to selling on a yield basis, with the top quality and highest yielding shares doing best. "But is it possible," you ask, "that the shares could have already discounted say $250 gold?" It is; it most definitely is. The market is the sum total of what everyone knows about everything, and that total contains a "mysterious knowledge" that surpasses the knowledge of any single man or group of men. Never, never, minimize the market's discounting ability.





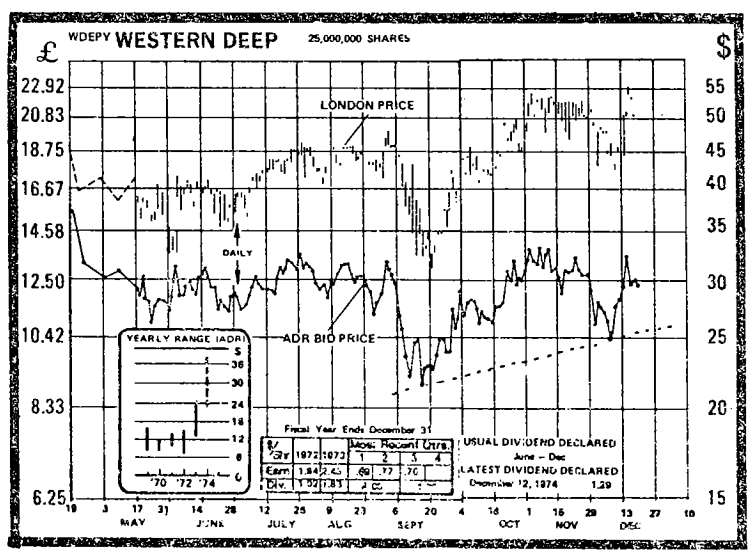
Now this is an important consideration that no one has discussed, but it is on my mind. Let's say that the big picture is still inflation and monetary debasement (following this recession). What is the best hedge against such a long-term situation? Is it gold shares that may have already discounted $250 gold or is it stocks selling at 10¢ on the dollar such as the ones I have been listing? The fact is that there is only one thoroughly deflated area in this economy and that area is common stocks. I think there is a fair chance that big money is now moving quietly into the huge values of common stocks rather than into the gold shares. Is one share of Homestake worth more than four shares of Woolworth when the book value of four shares of Woolworth is almost $120? That may be the way the unconscious of the market is thinking, and if so, it could account for the poor showing of the gold shares.

Personally, I do not see the point of going into all the ramifications of the gold picture at this time, the Treasury sales, the Proxmire bunk about more gold bullion sales, the fact that a big chunk of the US Treasury gold hoard is of non-marketable quality, the French revaluation of its gold reserves to market value, etc. All this is known by the market. Let's get into the gold action, the price movement.



First, the bullion momentum chart holds in a definite uptrend. Nothing wrong here, and this is bullish for bullion and the coins. So it seems (paradoxically) that an entirely different group is buying gold and gold bullion than the group dealing with the shares. I include my own daily ratio chart of Homestake, and the stock is now testing the 37 area support. If it breaks that, it will test the panic lows just below 30. The chart shows one factor clearly (at least to me) and that is that HM has discounted the best in the gold picture. Western Deep Levels looks a good deal better, and this is probably because the stock stands to increase dividends in the period ahead, perhaps substantially so. The stock held to a rising trendline that now comes in at about 25.

In short, the gold shares have not been acting well for some time, and this is the reason I have been advocating (and many of my cohorts have termed this "treasonous") reducing positions. In my opinion, "the big gold move" has not yet been seen, and it could be a year or so before it arrives. But the dollar is now very weak again, and the gold position remains an insurance against a sudden collapse in the dollar (although I do not see this happening right now). Advice: With gold positions in shares down to 10% to 15%, I would just sit tight. Those who are not prepared to hold the stocks for the next crisis (and there will be one) should scale them out and accept losses or profits as part of the game.



LATE NOTES: French President Giscard believes "all curves lead to catastrophe". He may well be right, but the most striking thing about this market at present, in my opinion, is the stubborn refusal of the D-J Transports to buckle. We still have a major downside nonconfirmation, and I don't care what the reason is. If the Transports won't go down (and ultimately below their 1974 low of 125.93) then we'll have an advance in this market.